ROUNDTABLE

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On an even keel

As Europe's private debt market continues to mature, investors are looking to capture opportunity and manage challenges. But how can the industry weather the next downturn when it finally arrives?

Even as economic growth has slowed in some of Europe's key economies, the continent's private debt market has maintained its strong momentum. In 2018, deals continued to flow, with Deloitte's most recent *Alternative Lender Deal Tracker* showing a 9 percent increase over the previous year in the volume for direct lenders.

And although fundraising was down last year on 2017, Europe's 29 percent share of the capital raised globally was just shy of the 31 percent peak in 2014, according to *PDI* figures, which suggests there remains a strong appetite for European private credit strategies.

Against this backdrop, we invited a panel of five top private debt professionals to discuss how the European industry is shaping up, new developments they are seeing in the market and what we are likely to see over the next 12-24 months.

Q How would you characterise the investment climate for private debt in Europe?

Daniel Heine: We are starting to see investors become more cautious in their commitments as there are concerns around whether the credit cycle is coming to an end. However, if you look at the actual market, the opposite appears to be true. There is still interesting and good quality dealflow coming through and, even with a bumpier economy ahead, this will help us in continuing to make sound investments, particularly in the special-situations universe. I am actually looking forward to the next few years.

Symon Drake-Brockman: Private equity across Europe remains active. In some markets, such as Germany, you're seeing more activity than has historically been the case. I'd say the demand side for finance remains reasonably robust. If there is a global slowdown, you just need to be more selective and more mindful of stress-testing opportunities.

Andrew Konopelski: If you look at direct lending – which sits in the middle of what has become quite a wide definition of private debt – it's still quite attractive when compared with other fixed-income and yield strategies. It now makes up quite an important part of limited partners' portfolios as they recognise that they receive a good pick-up in returns in exchange for only an incremental pick-up in risk. Being a sole lender in structures, as opposed to being a participant in syndications, is an attractive space to occupy from a returns perspective.

We certainly take the view that we're now pretty late in the credit cycle, but then I've been calling the top of the market since 2015. We've perhaps been a little overcautious for a couple of years now, but you do have to be mindful that, during your investment period, you are likely to see some kind

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Symon Drake-Brockman
Founder and managing partner
Pemberton

Drake-Brockman leads the development and execution of the firm's long-term strategy, takes an active role in the selection and structuring of investments, and oversees the ongoing management of funds. He was previously global head of debt markets at RBS.

Daniel Heine
Founder and managing director
Patrimonium

Heine is managing director of Patrimonium's private debt business as well as adjunct lecturer at the University of St Gallen Executive School. He was previously a financial consultant for Merrill Lynch International and a management consultant at AT Kearney.

Diala Minott
Partner
Paul Hastings

Minott is a structured credit partner in the London office of Paul Hastings. She specialises in structured credit finance transactions, including CLOs, CDOs and bespoke hybrid mid-market CLO-type funds as well as debt and credit funds, with a particular focus on direct lending.

Andrew Konopelski
Partner
EQT

Konopelski is head of credit strategies at EQT. He is also a member of the firm's executive committee and of the credit partners investment committee. Before joining in 2008, he worked for Tisbury Capital, where he helped manage its $1bn-plus credit portfolio.

Luke McDougall
Partner
Paul Hastings

McDougall is a London-based partner in the finance and leveraged finance practices. He focuses on UK and cross-border acquisition finance and restructuring and has experience acting for senior lenders, junior lenders and borrower groups as well as debt portfolio acquisitions.

"There is a lot of focus and scrutiny on UK-headquartered companies"

ANDREW KONOPELSKI
EQT

of recession or slowdown. We're definitely seeing more interest in special situations now – whether that's structuring solutions for companies looking to refinance debt or restructuring balance sheets. These strategies are coming into their own for LPs now.

Luke McDougall: In the work we're doing, we're definitely seeing a pick-up in restructurings of private debt deals, although this is primarily in the US so far. We're not seeing so much restructuring work in Europe, but where we are, it's mainly focused on syndicated loans and high-yield deals that are struggling rather than on large volumes of mid-market private debt deals.

Q What happens in the US often migrates over the Atlantic, so do you think we'll see more restructurings in Europe?

SD-B: There is a huge difference between the type of company that uses private debt in the US and that in Europe. In the US, all the first-tier suppliers – the ones that are integral to their customers' supply chains – are big companies, and they therefore tend to go to the capital markets for finance. It's mainly the third- or fourth-tier suppliers that sit in private debt portfolios in the US.

In Europe, by contrast, the first-tier suppliers are much smaller and so are highly relevant to the private debt market. Overall, the quality of business in European private debt portfolios is that much higher. If you talk to US players, they're likely to agree that some of the businesses they've financed are marginal companies that have kept going because of the reasonably strong economy.

Q What trends are you seeing in LP appetite for European private debt?

Diala Minott: We're seeing some interesting developments in a number of markets. There has been a relaxation of the laws governing limited partners' investment scope in countries such as Argentina and Brazil, and I think that will benefit private debt generally.

But we're definitely seeing more Asian interest in European private debt. In Japan, the regulator's understanding of CLOs and private debt funds is now more aligned with that of the European regime, and that is translating into Japanese investors becoming more comfortable with European funds. This has taken some time as LPs in Japan tend to go through highly detailed processes up to a year in advance of committing. But the general feeling is that once they are locked in, it's the start of a long-term relationship.

We're also seeing a similar pick-up in appetite for Europe among Korean investors. In the past it had been difficult to structure investments to comply with the Korean regulatory regime and there were issues around accounting system clashes, but these have been worked through. You now have single investment mandates that then invest in the pooled funds – this gives them the control they need.

Overall, we're now in a situation where most regulators understand how asset managers work and they no longer see private debt funds as shadow bankers. That's very helpful. And with the rise of co-investments, there's more understanding among LPs and more faith in the managers.

DH: We're seeing a lot more momentum, in particular from Asian investors. That appetite wasn't there before. Among Korean investors, you're seeing appetite develop along the same lines that the private debt market developed. They are experienced investors that have invested in the US for some time. The European market is clearly much younger, but Korean investors are now following the growth here. For managers in Europe, it is a relatively new phenomenon to go to Korea for fundraising, but it will become much more commonplace.

SD-B: The US market appears to be slowing down and that is affecting the appetite for Europe. Many US LPs are now fully allocated to US managers and so they are cautiously looking to Europe for opportunities, as are Asian investors, which are currently under-allocated. European investors are still actively investing in European private debt and, with yields continuing to be low, I can't see that changing over the short term. So, the overall appetite remains pretty strong for European private debt.

Q With continued opportunity and growing appetite among LPs, the European market is clearly on an even keel. But what surprises have you had over the past 12 months?

DH: I bet two years ago that interest rates would rise in Q3 2019 because I reasoned that the US economy would continue to improve. But, as we've seen in the US and Europe, that's not going to happen. But I was right about one thing: I agreed with the view that 2019 would be the year that the car industry model would change in Europe as we saw a move from the combustion engine to electric. That is clearly happening. In Europe, and in Germany in particular, that is having a tremendous effect on the auto supply sector – a large sector in Europe. It's definitely getting more bumpy.

DM: The rise of fund finance and fund leveraging hasn't been a surprise, but the levels we're now seeing are concerning. You have to ask how these funds will perform in a credit crunch. When you look at the borrowing base and asset base, it is interesting to see how different banks take different approaches. The new regulations on securitisations are affecting funds – they are now subject to regulations and have certain obligations, so it has been challenging to structure around this. The US is a bit more developed when it comes to fund leverage and their structures have been tested. European ones haven't and I do wonder how robust they are.

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> **LUKE MCDOUGALL**
> **Paul Hastings**

LM: This has largely happened because the community of banks that will lend to funds has multiplied. That will inevitably lead to keener terms and pricing. Ten to 15 years ago, you might have had banks insisting on asset vetoes, for example, and their own valuation methodologies, but these are being eroded because it's so competitive. Banks are having to trust the asset managers.

Q So should this be a cause for concern?

SD-B: Well, you're seeing more banks come to funds to provide leverage and then syndicate it to a large group of institutions sitting behind the banks and taking on the risk. Fundamentally, they're buying AAA at 200 over, which is a lot more than you get in the CLO market and the equity under you is much larger, so the risk you're taking is better.

"Most regulators now understand how asset managers work and they no longer see private debt funds as shadow bankers. That's very helpful"

DIALA MINOTT
Paul Hastings

Q It's hard to have any discussion about Europe without addressing the B word. How is Brexit shaping your thoughts and planning?

SD-B: LPs are becoming increasingly cautious about capital going into the UK. Every manager in Europe is being asked about their exposure to the UK and there is now a tightening of lending going into the UK market. Any deal that does get done has to be justified. That is not positive for the UK market over the medium term and it's compounded by the fact that uncertainty – which is reflected in consumer confidence and, in particular, in retail numbers – continues to be a drag on the UK economy.

DH: I fully agree. We're all facing that question: what's your UK exposure? And, of course, we're trying to keep it as small as possible at the moment. As a trend, this isn't great for the UK economy.

Andrew Konopelski: There is a lot of focus and scrutiny on UK-headquartered companies – and that's as it should be – but we're trying to help LPs understand where the actual risk lies. If you tell them you have an international business that happens to be based in the UK, they tend to look fearful, but then you have to demonstrate to them where the sales are so they can see where the real risks are.

There are still deals being done, but actually private equity firms have dampened their interest in the UK until they have more certainty around what will happen. So there is not unmet demand and margins haven't increased. The spread between sterling and the euro is widening as much as you might expect at a time of potential crisis.

DM: One thing we're seeing is more interest in speciality funds where the British Business Bank or insurers are trying to support the UK through, for example, UK real estate funds. The government has been looking at potential tax changes or measures on the fund side and now would be a good time to do this. Other jurisdictions

have been looking at their fund regimes as a result of Brexit to make them more competitive. There is scope for the UK to have a different type of fund structure. That would be helpful for the market.

Q Beyond UK exposure, what would you say are LPs' main concerns?

SD-B: Investors are cautious about credit, but they are in a bind. You're getting a negative yield on A-grade European corporate risk, yet you still need to reach your return target. And if you're nervous about credit, then you should probably be nervous about stock markets. Where can you put your capital? That's positive for private debt because LPs are largely underweight in the asset class. As much as there is talk of risk, there is demand because of the yields offered. But all this is leading LPs to focus on the scale of platforms because they want to manage that risk.

AK: One of the biggest changes over the past 12-24 months has been a shift of focus among LPs. Previously, they wanted to know about deal sourcing, convergence and deployment – they wanted to be sure you could get capital out the door. Now they assume you have all this. The focus now is on the quality of introductions and diligence and, increasingly, on monitoring and restructuring. Do you have the capabilities and talent you need to deal with problems? Because even if you don't have issues now, you could in one to two years.

LPs now know the managers, they have a big dataset and they know the market much better. They're asking more sophisticated questions and digging into individual credits. Their knowledge has increased substantially. It means they're investing less thematically and more according to who the runners and riders are and who has the right skillset to manage through the crisis.

Q So how well prepared is Europe's private debt market for a future downturn and how is this informing your strategy?

DM: One of the big lessons from the credit crisis is the need for mixed teams with a mix of skill sets. Restructuring expertise is now a must-have rather than a just-in-case. Vehicles will be much more robust this time. There is so much regulation and legislation now. AIFMD and securitisation regulation, for example, have yet to be tested in a downturn, but I think they will help stabilise the market in more difficult times.

> *"As a lender, you need to understand societal changes and what the implications are"*
>
> **SYMON DRAKE-BROCKMAN**
> **Pemberton**

"We're working on the assumption that the economy will turn"

DANIEL HEINE
Patrimonium

AK: The bar is high for cyclical businesses – even those that are good and that will almost certainly come through the cycle. That's because we know we'll have some heartache somewhere in the middle. You have to ask how much you want your team to be spending time dealing with issues when you'd prefer them to spend time looking at new investments.

In a downturn, you want to continue moving forwards.

DH: We're working on the assumption that the economy will turn. There is a manufacturing recession looming over Europe. You can still finance manufacturing businesses, but then it becomes more of a special-situation or opportunity credit than in the past, when many of these businesses would have been in a more plain-vanilla lending situation.

When it comes to how well-prepared funds are for a downturn, it's largely a resource question as to whether you can manage through difficult times. Larger managers typically run different strategies in addition to direct lending – they'll have credit opportunity and special-situations teams as well. The day-to-day business of these teams is restructuring work and so, should things go bad, you already have the resource internally.

SD-B: Leading LPs expect you to have strong monitoring and restructuring capability and they want to know you have the scale of resource internally to manage difficult situations. We've had this in place for five years. LPs have got to the point where they are saying that if they are going to give you capital to manage, you have to have the full set of equipment.

But on the manufacturing side, we take a slightly different view. If you are a first-tier supplier, you're unlikely to default; if you're third- or fourth-tier, you'll get hammered in a downturn. Customers move their order book up to the first-tier suppliers to keep them going because there's such an interdependency between them. And, as I said earlier, the first-tier suppliers in Europe are still very much of the size to be in private debt territory.

I'd also say that we're going through huge shifts at the moment with electric cars, WeWork, Amazon, etc, and these shifts are changing society and people's spending habits. As credit managers, we spend a lot of time talking about where we are in the cycle, but the reality is that a lot of industries are going to be killed by technology regardless. As a lender, you need to understand societal changes and what the implications are. ■